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BEFORE THE ARIZONA CORPORATION CC

COMMISSIONERS

GARY PIERCE - CHAIRMAN  
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Arizona Corporation Commission

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ARIZONA CORPORATION COMMISSION  
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IN THE MATTER OF THE APPLICATION OF  
CHINO MEADOWS II WATER COMPANY  
FOR A RATE INCREASE.

DOCKET NO. W-02370A-10-0519

STAFF'S CLOSING BRIEF

**I. Introduction**

On December 9, 2011, Staff filed its opening brief in the above captioned matter. The opening brief was intended to be Staff's comprehensive recommendation on all issues presented in this case. Staff continues to rely on the arguments it presented in its opening brief. However, after review of the Company's initial closing brief, Staff feels it is necessary to respond to additional arguments presented within the Company's brief.

**II. Discussion**

**A. Operating Margins**

The Company persists in its arguments regarding its preference to utilize an operating margin to determine the operating income for the Company. The Company's arguments continue to ignore that rate of return methodology is the Commission's preferred means of establishing an operating income for a utility, is consistent with regulatory framework related to establishing rates for public service corporations, and is appropriate for a utility of Chino Meadows' size.

The Company's argument in favor of continuing to use an operating margin despite the merits of rate of return methodology appears to turn on Commission precedent for using operating margins for smaller utilities with little or no rate base. Company's Initial Brief at 1:8, 1:10, 1:13, 5:3, 7:1. Staff asserts as an initial matter that the Commission is not bound by precedent. *See e.g. Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 863-64, 104 S.Ct. 2778, 2792

1 (1984) (agency must evaluate on continuing basis the wisdom of its policies and is consequently not  
2 bound by its prior determinations); *Redlark v. Commissioner of Internal Revenue*, 141 F.3d 936, 941  
3 (9th Cir. 1998) (breaking with past practice of the agency does not, without more, call into question  
4 propriety or reasonableness of new practice).

5         Additionally, the Company contends that the appropriate use of rate of return methodology, as  
6 Staff recommends for the Company, is somehow unfair and inconsistent with regulatory practice for  
7 a utility like Chino Meadows. Company's Initial Brief at 7:1. However, as was explained thoroughly  
8 within Staff's opening brief, there are several significant reasons why rate of return methodology is  
9 appropriate under the circumstances and is thoroughly consistent with regulatory practice.

10         Use of rate of return methodology for a utility of Chino Meadows' size is not discriminatory  
11 or unfair either, contrary to the Company's characterization of Staff's recommendation. *Id.* at 4:1,  
12 4:12-14. In order to cast the Staff recommendation as discriminatory, the Company offers a selection  
13 of various rate case decisions that provided operating incomes on the basis of operating margin  
14 analysis. *Id.* at 3-4. From this selection of rate case determinations, the Company derived an average  
15 operating margin for the group of 14.15 percent. *Id.* at 4. This average is not evidence, however, of  
16 an objectively reasonable operating margin that is representative for all small utilities. As Chino  
17 Meadows notes in a footnote, the list of rate decisions it provided on the subject of operating margins  
18 is not comprehensive. *Id.* at 3, FN 4.

19         Moreover, an average of recently approved operating margins would not be evidence of what  
20 an appropriate operating margin would be were it appropriate to utilize one in this case. Within the  
21 selection of rate decisions cited by Chino Meadows, there is a range from 10 percent to 22.31  
22 percent. *Id.* at 3-4. Operating margins that are even lower have been approved, as for instance in the  
23 Johnson Utilities rate case approved by Decision No. 71854 (August 25, 2010). In Johnson Utilities,  
24 an operating margin of only 3 percent was awarded for both the water and wastewater systems  
25 (although the wastewater system was later approved for an 8.0 percent rate of return on fair value rate  
26 base by amendment in Decision No. 72579 (September 15, 2011) at 4). In particular, the Johnson  
27 Utilities decision made clear that determination of an appropriate operating margin is heavily  
28 dependent on the circumstances of the case. *See* Decision No. 71854 at 49:9-50:12 (discussing why

1 an operating margin approach is necessary due to lack of rate base to produce a positive income while  
2 noting that even a 10 percent operating margin would produce a windfall return to the utility owners  
3 in that circumstance).

4 What is unclear from the selection of rate case decisions presented by Chino Meadows in its  
5 brief are the particular circumstances demonstrating why an operating margin would be appropriate  
6 in those particular cases. The Company did not note whether any of the cited cases involved utilities  
7 with negative or negligible rate bases as proved problematic in the Johnson Utilities decision. In fact  
8 the Commission approved a negative rate base for H2O, Inc. in Decision No. 71414 which Chino  
9 Meadows includes in its list. Decision No. 71414 (December 8, 2009) at 16:4-5. The Commission  
10 also approved a negative rate base in the Appaloosa rate case which Chino Meadows cites. Decision  
11 No. 71236 (August 6, 2009) at 10:23. In addition to a negative rate base, Appaloosa was confronted  
12 with having to obtain a Water Infrastructure Financing Authority loan in order to construct costly  
13 arsenic treatment facilities. *Id.* at 19-20.

14 Likewise, Chino Meadows did not distinguish whether any of its selected rate case decisions  
15 involved non-profit utilities. In fact the Yarnell, Ashfork, and Ehrenberg associations' rate decisions  
16 that Chino Meadows cites are all non-profit utilities for which a rate of return on the fair value of rate  
17 base methodology would be inappropriate. *See* Decision No. 70698 (January 20, 2009) at 3:12-14;  
18 Decision No. 71181 (June 30, 2009) at 1:27; Decision No. 71505 (March 17, 2010) at 2:3.

19 Consideration of just the two issues of negative rate bases and non-profit status of the utilities  
20 eliminates more than a third of the cited rate decisions Chino Meadows relies on for the proposition  
21 that Staff's rate of return recommendation is discriminatorily low and inappropriate for a utility of the  
22 Company's size. Moreover, the Yarnell, Ehrenberg and Appaloosa rate decisions are the highest  
23 Commission awarded operating margins cited by Chino Meadows.

24 Staff would note that the Company likewise includes the Wickenburg Ranch Water, LLC as  
25 an operating margin rate case and asserts that a 23.1 percent operating margin was approved in that  
26 case. Company's Initial Brief at 3 citing Decision No. 70741 (February 12, 2009). Staff would  
27 clarify that the Commission did not approve an operating margin in Wickenburg Ranch, although the  
28 utility proposed one of 10.81 percent in that case. Decision No. 70741 at 13:2. Rather, Staff

1 recommended, and the Commission adopted an 8.0 percent rate of return on fair value rate base in  
2 Wickenburg Ranch. Decision No. 70741 at 13:7-9, 16:23-24. Additionally, Chino Meadows  
3 includes the Abra Water, Southland Utilities, and Las Quintas Serenas rate decisions in its table of  
4 operating margin rate decisions. In both Abra and Las Quintas Serenas, the utilities proposed rate of  
5 return methodologies to determine the appropriate operating income although the Commission  
6 ultimately adopted Staff's recommended rate of returns in both cases. Decision No. 72287 (May 4,  
7 2011) at 12:16-18; Decision No. 72498 (July 25, 2011) at 14:12. In Southland Utilities, as with  
8 Wickenburg Ranch and the present case, the utility proposed an operating margin, in that case of  
9 23.29 percent. Decision No. 72429 (June 24, 2011) at 9, FN 19. There too, the Commission adopted  
10 Staff's rate of return based recommendation. *Id.* at 11:11-13.

11 Tellingly, these four cases of Wickenburg Ranch, Abra, Southland and Las Quintas Serenas  
12 amount to nearly a third of the decisions that Chino Meadows cites as operating margin cases for  
13 utilities of comparable size. Each of them was approved by the Commission for a rate of return  
14 rather than an operating margin. Likewise, despite rate base differences, the operating incomes they  
15 approved were consistent with what Staff recommends for Chino Meadows. For example, in  
16 Southland, a utility with roughly double the \$212,349 rate base of Chino Meadows at \$417,978, the  
17 Commission authorized an operating income based on rate of return methodology of \$41,798, again  
18 roughly double the \$20,385 operating income Staff is recommending for Chino Meadows in this  
19 case. *See* Decision No. 72429 at 7:25, 11:11-13. Clearly, the same examples provided by Chino  
20 Meadows on brief demonstrate that Staff's recommendation of a rate of return premised operating  
21 income is fair and consistent with regulatory practice for like situated utilities.

22 Consequently, Staff's recommendation is fair and nondiscriminatory. Likewise, as described  
23 both here and in Staff's discussion of rate of return in its Opening Brief, Staff's rate of return  
24 recommendation is appropriate under the circumstances specific to this case.

#### 25 **B. Revenue Requirement**

26 The Company and Staff remain in disagreement over a number of issues related to operating  
27 expenses. Briefly, these issues relate either to salary expense, leak detection program expense and  
28

1 miscellaneous expense. Staff continues to recommend the adoption of its positions on each of these  
2 matters.

### 3                   1.     Salary Expense

4           There are two principle salary related issues in contention between Staff and the Company:  
5 employee bonuses and executive compensation. With respect to employee bonuses, the only basis  
6 provided for them in evidence was a summary schedule that explained they should be permitted as  
7 they are ordinary for other utilities. Exhibit A-4, Schedule RLJ-30. However, the Company provided  
8 no evidence to substantiate that it is a commonly allowed expense or that it is necessary to maintain  
9 continuous adequate service. As explained by Staff witness Brown,

10           The Company has provided no studies or other type of documentation to show that the  
11 removal of \$1,600 in total bonuses would cause a higher than normal turnover in  
12 employees. Bonuses are an optional cost and, therefore, should be recognized below-  
the-line (i.e., removed from rates).

13 Exhibit S-5, Surrebuttal Testimony of Crystal Brown at 7:8-11.

14           On brief, the Company asserts that it is necessary to provide bonuses to encourage employee  
15 retention and incent good customer service among other reasons. Company's Initial Brief at 7:5-11.  
16 Otherwise, explains the Company, it would have to raise base salaries to remain competitive in the  
17 market. *Id.* However, Chino Meadows still fails to provide any factual corroboration of that  
18 contention. Furthermore, the Company has proposed, and Staff recommended adoption of multiple  
19 base salary increases in this case. *See* Exhibit S-6, Brown Supplemental Surrebuttal at 8-9. Therefore,  
20 Staff continues to recommend denial of the Company's requested employee bonus expense.

21           Likewise, the Company's arguments for inclusion of the full requested amount for executive  
22 compensation are unsupported and should be denied. On brief, Chino Meadows criticizes the Staff  
23 analysis which led to Staff's recommendation but still fails to provide time sheet data or any other  
24 basis to substantiate the requested expense amount. Company's Initial Brief at 7:20-8:8. Staff's  
25 analysis was reasonable and appropriate in light of the absence of any evidence to demonstrate the  
26 actual time spent by Mr. Levie managing the Company amid his management of several other  
27 ventures from the same office. Rather, the Company's argument misses the point that it bears the  
28

1 burden of demonstrating the appropriateness of its requested expense adjustment. As such, Staff  
2 continues to believe that its recommendation is reasonable and should be adopted.

### 3 **2. Miscellaneous Expense**

4 As with employee bonuses, the first explanation of the appropriateness of the miscellaneous  
5 expenses was in the form of an annotation to a summary schedule explaining the ongoing disputed  
6 issues between Staff and the Company. Exhibit A-4, Schedule RLJ-30. As the Company has  
7 provided no new basis to support the inclusion of this expense that Staff did not already respond to in  
8 its Opening Brief, Staff relies on the arguments made in its Opening Brief as to why Staff's  
9 recommendation should be adopted on this issue.

### 10 **3. Leak Detection Expense**

11 With respect to recovering the expenses related to the Company's leak detection program,  
12 Staff has explained that there is no expense to recover until there is a leak detection program in place.  
13 The Company did not implement the leak detection program at any point prior to the filing of the  
14 current rate application, nor by the time that prefiled testimony was docketed. Exhibit S-5 Brown  
15 Surrebuttal at 11. Because the Company is not currently paying this expense, nor was it during the  
16 test year, nor even prior to the hearing, there is nothing unfair about Staff's recommendation not to  
17 allow recovery of an expense that Chino Meadows has not experienced and may never experience if  
18 it ultimately does not implement the program. When the Company implements the program and  
19 incurs costs related to it, it can recover those in a future rate case. Staff's recommendation is  
20 reasonable and should be adopted.

### 21 **C. Rate Design**

22 Although Staff and the Company are both proposing to use an inverted tier, conservation  
23 encouraging rate design, dispute remains over the amount to be recovered in the fixed component of  
24 monthly charges as opposed to the volumetric commodity rate. The Company contends on brief for  
25 the first time that Staff's recommendation is punitive. Company's Initial Brief at 10:16-17. The  
26 Company's contention is unsupported by any evidence either prefiled or supplied orally at hearing.  
27 Chino Meadows has not established that the rate design that Staff recommends will in fact cause  
28

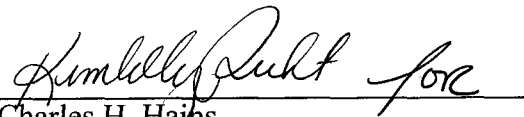
1 conservation by existing customers greater than would be incurred under the Company's proposed  
2 rate design.

3 By building in a greater proportion of its revenue recovery into fixed monthly minimums, the  
4 Company's proposal moves it closer to a guaranteed rate recovery rather than the typical opportunity  
5 to earn its authorized rates. Guaranteed rates are neither required by law, nor are they desirable  
6 insofar as they immunize utilities from the incentive to maintain efficient and effective utility service.  
7 In light of the absence of evidence suggesting that Staff's rate design will produce more conservation  
8 than the Company's proposal, Staff maintains that its recommendation is reasonable and should be  
9 adopted.

10 **III. Conclusion**

11 For all the above stated reasons and those expressed within Staff's Opening Brief, Staff's  
12 recommendations are reasonable and should be adopted.

13  
14 RESPECTFULLY SUBMITTED this 30th day of December, 2011.

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16   
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